

Share Issuances to Consultants, Employees and Directors for Compensation and Severance

During the year ended September 30, 2019, the Company issued 18,900 shares of its common stock related to an employee separation agreement with a fair value of approximately \$18,000 or \$0.97 per share.

During the year ended September 30, 2019, the Company issued 7,060,754 shares of its common stock and recorded compensation expense of \$10.182 million, which included the issuance of 2,757,002 shares which were the result of the board of directors granting the modification to holders of options that reduced the exercise price of those options.

During the year ended September 30, 2019, the Company granted options to acquire 210,000 shares of its common stock at an exercise prices ranging from \$.08 to \$2.40 per share. During the year ended September 30, 2019, the Company granted warrants to acquire 1,350,000 shares of its common stock at exercise prices ranging from \$1.70 to \$2.40 per share.

In the year ended September 30, 2018, the Company issued 1,055,416 shares of its common stock to consultants, employees and directors as compensation for services. In the year ended September 30, 2018, the Company issued warrants to acquire 20,000 shares of its common stock to a consultant with an exercise price of \$2.40 per share for services. In the year ended September 30, 2018, the Company issued options to acquire 2,105,000 shares of its common stock with exercise prices ranging from \$2.23 to \$4 per share to consultants, employees and directors for services. In the year ended September 30, 2018, options to acquire 160,000 shares of stock were exercised on a cashless basis and the Company issued 65,558 shares of its common stock in satisfaction of the cash exercises.

The securities issued in the above-mentioned transactions were issued in connection with private placements exempt from the registration requirements of Section 5 of the Securities Act of 1933, as amended, pursuant to the terms of Section 4(2) of that Act and Rule 506 of Regulation D.

CD Special Warrants Offering

On December 27, 2018, the Company closed the first tranche of the Offering consisting of 3,121 CD Special Warrants at a price of C\$1,000 per CD Special Warrant for aggregate gross proceeds of C\$3,121,000 (see **CD Special Warrant Offering**, above).

On March 14, 2019, the Company closed the second tranche of the Offering consisting of 962 CD Special Warrants at a price of C\$1,000 per CD Special Warrant for aggregate gross proceeds of C\$962,000 (see **CD Special Warrant Offering**, above).

ITEM 6. SELECTED FINANCIAL DATA

Pursuant to permissive authority under Regulation S-K, Rule 301, we have omitted Selected Financial Data.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Note Regarding Forward-Looking Information and Factors That May Affect Future Results

This annual report on Form 10-K contains forward-looking statements regarding our business, financial condition, results of operations and prospects. The Securities and Exchange Commission (the "SEC") encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This annual report on Form 10-K and other written and oral statements that we make from time to time contain such forward-looking statements that set out anticipated results based on management's plans and assumptions regarding future events or performance. We have tried, wherever possible, to identify such statements by using words such as "anticipate," "estimate," "expect," "project," "intend," "plan," "believe," "will"

and similar expressions in connection with any discussion of future operating or financial performance. In particular, these include statements relating to future actions, future performance or results of current and anticipated sales efforts, expenses, the outcome of contingencies, such as legal proceedings, and financial results. Factors that could cause our actual results of operations and financial condition to differ materially are set forth in the “Risk Factors” section of this annual report on Form 10-K

We caution that these factors could cause our actual results of operations and financial condition to differ materially from those expressed in any forward-looking statements we make and that investors should not place undue reliance on any such forward-looking statements. Further, any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of anticipated or unanticipated events or circumstances. New factors emerge from time to time, and it is not possible for us to predict all such factors. Further, we cannot assess the impact of each such factor on our results of operations or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

The following discussion should be read in conjunction with our audited financial statements and the related notes that appear elsewhere in this annual report on Form 10-K.

RESULTS OF OPERATIONS

The following comparative analysis on results of operations was based primarily on the comparative consolidated financial statements, footnotes and related information for the periods identified below and should be read in conjunction with the audited consolidated financial statements and the notes to those statements for the years ended September 30, 2019 and 2018, which are included elsewhere in this annual report on Form 10-K. The results discussed below are for the years ended September 30, 2019 and 2018 (in thousands).

| | Years Ended September | | Change | |
|------------------------------------|-----------------------|-------------------|---------------|---------------|
| | 2019 | 2018 | \$ | % |
| Revenue | \$ 2,451 | \$ 1,296 | \$ (1,155) | (89%) |
| Cost of goods sold | (1,935) | - | \$ 1,935 | N/A |
| Consulting fees | (2,914) | (1,054) | \$ 1,860 | (176%) |
| Professional fees | (1,454) | (779) | \$ 675 | (87%) |
| General and administration | (14,920) | (7,860) | \$ 7,060 | (90%) |
| Loss from equity method investees | (6,547) | - | \$ 6,547 | N/A |
| Loss on extinguishment of rent | (1,159) | - | \$ 1,159 | N/A |
| Impairment of PP&E and intangibles | (2,132) | - | \$ 2,132 | N/A |
| Other income (expenses), net | (375) | (301) | \$ 74 | (25%) |
| Net loss | \$ (28,985) | \$ (8,698) | 20,287 | (233%) |

Revenues

In 2019, the Company now engages directly in the cultivation, production and sale of cannabis and related products. Prior to 2019, the Company was engaged in renting properties used in the cultivation, production and sale of cannabis. Therefore, comparison of revenue between the two periods is comparing disparate business models. 100% of the revenue in 2019 is from the cultivation, production and sale of cannabis, and related. 100% of the revenue from 2018 is from rental of real estate. Going forward, the cultivation, production and sale of cannabis related products will constitute most of the Company’s revenues.

In 2019, all of the Company's revenue originates in the state of Oregon. Going forward the Company expects to begin realizing revenue from the states of Nevada and California in the near future. The Company has also targeted Florida, Maryland, Massachusetts and it has also begun working towards its investments obtaining licenses in Eswatini.

Cost of Revenues

Cost of revenues for the year ended September 30, 2019 totaled approximately \$1.9 million and consisted of contracted labor, growing and trimming expenses, and product testing. No cost of revenues was recognized during the year ended September 30, 2018. The Company expects its cost of revenues to grow in line with its future revenue growth.

Operating Expenses

Consulting Fees

Consulting fees for the years ended September 30, 2019 and 2018 totaled approximately \$2.9 million and \$1.1 million, respectively. The increase of \$1.9 million is primarily related to stock-based compensation expenses recognized during the year ended September 30, 2019 for restricted stock awards and warrants to acquire the Company's common stock issued to consultants.

Professional Fees

Professional fees for the years ended September 30, 2019 and 2018 totaled approximately \$1.5 million and \$0.8 million, respectively. The increase of \$0.7 million is primarily related to legal, accounting and other professional fees incurred during the year ended September 30, 2019. We expect our professional fees to increase as we continue to grow our business.

General and Administrative

General and administrative expenses for the years ended September 30, 2019 and 2018 totaled approximately \$14.9 million and \$7.9 million, respectively. The increase of \$7.0 million is primarily related to increases in salaries and wages and stock-based compensation expense for restricted stock awards and options and an increase of general and administrative costs of \$1.0 million (insurance, rent, etc.).

Impairment of Property and Equipment and Intangibles

Impairment expenses related to property and equipment totaled approximately \$1.7 million for the year ended September 30, 2019. We recorded an expense of \$1.0 million related to our property and equipment acquired with our acquisition of Never Again Real Estate and Never Again 2 Real Estate and \$0.7 million in other related properties.

Impairment expenses related to intangible assets totaled approximately \$0.5 million for the year ended September 30, 2019 and were incurred in connection with our investment in YMY. This impairment is with respect to the granting of an option to effectuate the balance of one hundred percent of an acquisition that never took place.

Loss on Extinguishment of Rent

Loss on extinguishment of rent expense for the year ended September 30, 2019, was approximately \$1.1 million and was related to deferred rent.

Other Income (Expense)

Other expenses for the years ended September 30, 2019 and 2018, totaled approximately \$0.4 million and \$0.3 million, respectively. Interest expense increased by \$2.2 million in fiscal 2019 compared to fiscal 2018. That increase was

primarily the result of our new borrowings from Canaccord convertible notes and the discounts associated with the notes. This increase in interest expense was offset by \$2.2 million in gains from the reduction of liabilities that resulted from the bifurcation of certain embedded features in the Canaccord convertible notes and warrants that the Company treated as liabilities.

Loss from Equity Method Investees

In 2019, we incurred losses from equity method investees of approx. \$6.5 million. This loss was primarily the result of fully impairing the investment of \$5.7 million in Stempro International acquired from our acquisition of South African Ventures and fully impairing the investment of \$0.5 million in SOK Management and related investees.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2019, we had negative working capital of approximately \$2.6 million, which included cash and cash equivalents of \$3.3 million. We reported a net loss of approximately \$29 million and our net cash used in operating expenses totaled \$6.5 million, our cash provided by investing activities was \$6.3 million and cash flows from financing activities totaled \$2.8 million. We are currently negotiating with certain mortgage lenders to extend the maturity of their notes.

Subsequent to September 30, 2019, we received gross proceeds from the sale of promissory notes of \$1.0 million. In addition, we believe we will closing in the near future on a \$10 million investment for the issuance of a new class of preferred shares by the Company.

Going Concern

At September 30, 2019, the Company had approximate balances of cash and cash equivalents of \$3.3 million, negative working capital of \$2.6 million, total stockholders' equity of \$23.6 million and an accumulated deficit of \$37.1 million.

These audited consolidated financial statements have been prepared on a going concern basis, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business.

While the recreational use of cannabis is legal under the laws of certain States, where the Company has and is working towards further finalizing the acquisition of entities or investment in entities that directly produce or sell cannabis, the use and possession of cannabis is illegal under United States Federal law for any purpose, by way of Title II of the Comprehensive Drug Abuse Prevention and Control Act of 1970, otherwise known as the Controlled Substances Act of 1970 (the "ACT"). Cannabis is currently included under Schedule 1 of the Act, making it illegal to cultivate, sell or otherwise possess in the United States.

On January 4, 2018 the office of the Attorney General published a memo regarding cannabis enforcement that rescinds directives promulgated under former President Obama that eased federal enforcement. In a January 8, 2018 memo, Jefferson B. Sessions, then Attorney General of the United States, indicated enforcement decisions will be left up to the U.S. Attorney's in their respective states clearly indicating that the burden is with "*federal prosecutors deciding which cases to prosecute by weighing all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of federal prosecution, and the cumulative impact of particular crimes on the community.*" Subsequently, in April 2018, President Trump promised to support congressional efforts to protect states that have legalized the cultivation, sale and possession of cannabis, however, a bill has not yet been finalized in order to implement legislation that would, in effect, make clear the federal government cannot interfere with states that have voted to legalize cannabis. Further in December 2018, the US Congress passed legislation, which the President signed on December 20, 2018, removing hemp from being included with Cannabis in Schedule I of the Act.

These conditions raise substantial doubt as to the Company's ability to continue as a going concern should it complete its acquisitions and investments, which it considers likely as of the date of these consolidated financial statements. Should the United States Federal Government choose to begin enforcement of the provisions under the Act, the Company through its wholly owned subsidiaries could be prosecuted under the Act and the Company may have to immediately cease operations and/or be liquidated upon their closing of the acquisition or investment in entities that engage directly in the production and or sale of cannabis.

Management believes that the Company has access to capital resources through potential public or private issuances of debt or equity securities. However, if the Company is unable to raise additional capital, it may be required to curtail operations and take additional measures to reduce costs, including reducing its workforce, eliminating outside consultants and reducing legal fees to conserve its cash in amounts sufficient to sustain operations and meet its obligations. These matters raise substantial doubt about the Company's ability to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might become necessary should the Company be unable to continue as a going concern.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements. The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with revenue recognition, investments, intangible assets, stock-based compensation and business combinations.

The Company's financial position, results of operations and cash flows are impacted by the accounting policies the Company has adopted. In order to get a full understanding of the Company's financial statements, one must have a clear understanding of the accounting policies employed. A summary of the Company's critical accounting policies follows:

Revenue Recognition

The Company recognizes revenue in accordance with ASC 605, "Revenue Recognition." Revenue is realized or realizable and earned when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) the sales price is fixed or determinable, (3) collectability is reasonably assured, and (4) products have been shipped and the customer has taken ownership and assumed risk of loss.

Cannabis Dispensary, Cultivation and Production

The Company recognizes revenue as earned when the following four criteria have been met: (i) when persuasive evidence of an arrangement exists, (ii) the product has been delivered to a customer, (iii) the sales price is fixed or determinable, and (iv) collection is reasonably assured. Revenue is recognized net of sales incentives and returns, after discounts for the assurance program, veterans coverage program and compassionate programs.

Leasing Operations

The Company recognizes rental revenue from tenants, including rental abatements, lease incentives and contractual fixed increases attributable to operating leases, on a straight-line basis over the term of the related leases when collectability is reasonably assured.

The Company makes estimates of the collectability of its tenant receivables related to base rents, straight-line rent and other revenues. In the current fiscal year, the Company began significant rental operations. The Company considers such things as historical bad debts, tenant creditworthiness, current economic trends, facility operating performance, lease structure, developments relevant to a tenant's business, and changes in tenants' payment patterns in its analysis of accounts receivable and its evaluation of the adequacy of the allowance for doubtful accounts. Specifically, for straight-line rent receivables, the Company's assessment includes an estimation of a tenant's ability to fulfill its rental obligations over the remaining lease term.

Stock-based Compensation

The Company accounts for share-based payment awards exchanged for services at the estimated grant date fair value of the award. Stock options issued under the Company's long-term incentive plans are granted with an exercise price equal to no less than the market price of the Company's stock at the date of grant and expire up to ten years from the date of grant. These options generally vest on the grant date or over a one-year period.

The Company estimates the fair value of stock option grants using the Black-Scholes option pricing model and the assumptions used in calculating the fair value of stock-based awards represent management's best estimates and involve inherent uncertainties and the application of management's judgment.

Expected Term - The expected term of options represents the period that the Company's stock-based awards are expected to be outstanding based on the simplified method, which is the half-life from vesting to the end of its contractual term.

Expected Volatility - The Company computes stock price volatility over expected terms based on its historical common stock trading prices.

Risk-Free Interest Rate - The Company bases the risk-free interest rate on the implied yield available on U. S. Treasury zero-coupon issues with an equivalent remaining term.

Expected Dividend - The Company has never declared or paid any cash dividends on its common shares and does not plan to pay cash dividends in the foreseeable future, and, therefore, uses an expected dividend yield of zero in its valuation models.

Effective January 1, 2017, the Company elected to account for forfeited awards as they occur, as permitted by Accounting Standards Update ("ASU") 2016-09. Ultimately, the actual expenses recognized over the vesting period will be for those shares that vested. Prior to making this election, the Company estimated a forfeiture rate for awards at 0%, as the Company did not have a significant history of forfeitures.

Impairment of Long-Lived Assets

The Company reviews the carrying value of its long-lived assets, which include property and equipment, for indicators of impairment whenever events or changes in circumstances indicate that the carrying value of an asset or asset group may not be recoverable. The Company considers the following to be some examples of important indicators that may trigger an impairment review: (i) significant under-performance or losses of assets relative to expected historical or projected future operating results; (ii) significant changes in the manner or use of assets or in the Company's overall strategy with respect to the manner or use of the acquired assets or changes in the Company's overall business strategy; (iii) significant negative industry or economic trends; (iv) increased competitive pressures; (v) a significant decline in the Company's stock price for a sustained period of time; and (vi) regulatory changes. The Company evaluates assets for potential impairment indicators at least annually and more frequently upon the occurrence of such events. The Company does not test for impairment in the year of acquisition of properties so long as those properties are acquired from unrelated third parties.

The Company assesses the recoverability of its long-lived assets by comparing the projected undiscounted net cash flows associated with the related long-lived asset or group of long-lived assets over their remaining estimated useful lives against their respective carrying amounts. In cases where estimated future net undiscounted cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the

fair value of the asset or asset group. Fair value is generally determined using the assets expected future discounted cash flows or market value, if readily determinable. If long-lived assets are determined to be recoverable, but the newly determined remaining estimated useful lives are shorter than originally estimated, the net book values of the long-lived assets are depreciated and amortized prospectively over the newly determined remaining estimated useful lives.

Goodwill and Intangible Assets

Goodwill. Goodwill represents the excess acquisition cost over the fair value of net tangible and intangible assets acquired. Goodwill is not amortized and is subject to annual impairment testing on or between annual tests if an event or change in circumstance occurs that would more likely than not reduce the fair value of a reporting unit below its carrying value. In testing for goodwill impairment, the Company has the option to first assess qualitative factors to determine whether the existence of events or circumstances lead to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events and circumstances, the Company concludes that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is not required. If the Company concludes otherwise, the Company is required to perform the two-step impairment test. The goodwill impairment test is performed at the reporting unit level by comparing the estimated fair value of a reporting unit with its respective carrying value. If the estimated fair value exceeds the carrying value, goodwill at the reporting unit level is not impaired. If the estimated fair value is less than the carrying value, further analysis is necessary to determine the amount of impairment, if any, by comparing the implied fair value of the reporting unit's goodwill to the carrying value of the reporting unit's goodwill.

Intangible Assets. Intangible assets deemed to have finite lives are amortized on a straight-line basis over their estimated useful lives, where the useful life is the period over which the asset is expected to contribute directly, or indirectly, to our future cash flows. Intangible assets are reviewed for impairment on an interim basis when certain events or circumstances exist. For amortizable intangible assets, impairment exists when the carrying amount of the intangible asset exceeds its fair value. At least annually, the remaining useful life is evaluated.

An intangible asset with an indefinite useful life is not amortized but assessed for impairment annually, or more frequently, when events or changes in circumstances occur indicating that it is more likely than not that the indefinite-lived asset is impaired. Impairment exists when the carrying amount exceeds its fair value. In testing for impairment, the Company has the option to first perform a qualitative assessment to determine whether it is more likely than not that an impairment exists. If it is determined that it is not more likely than not that an impairment exists, a quantitative impairment test is not necessary. If the Company concludes otherwise, it is required to perform a quantitative impairment test. To the extent an impairment loss is recognized, the loss establishes the new cost basis of the asset that is amortized over the remaining useful life of that asset, if any. Subsequent reversal of impairment losses is not permitted.

Principals of Consolidation

The Company's policy is to consolidate all entities that it controls by ownership of a majority of the outstanding voting stock. In addition, the Company consolidates entities that meet the definition of a variable interest entity ("VIE") for which it is the primary beneficiary. The primary beneficiary is the party who has the power to direct the activities of a VIE that most significantly impact the entity's economic performance and who has an obligation to absorb losses of the entity or a right to receive benefits from the entity that could potentially be significant to the entity. For consolidated entities that are less than wholly owned, the third party's holding of equity interest is presented as noncontrolling interests in the Company's Consolidated Balance Sheets and Consolidated Statements of Changes in Stockholders' Equity. The portion of net loss attributable to the noncontrolling interests is presented as net loss attributable to noncontrolling interests in the Company's Consolidated Statements of Operations.

The accompanying consolidated financial statements include the accounts of Stem Holdings, Inc. and its wholly-owned subsidiaries, Stem Holdings Oregon, Inc., Stem Holdings IP, Inc., Opco, LLC, Stem Agri, LLC., Stem Group Oklahoma, Inc. and Stem Holdings Florida, Inc. All material intercompany accounts, transactions, and profits have been eliminated in consolidation. Our wholly owned subsidiaries had no operations, assets or liabilities as of September 30, 2019.

Equity Method Investments

Investments in unconsolidated affiliates are accounted for under the equity method of accounting, as appropriate. The Company accounts for investments in limited partnerships or limited liability corporations, whereby the Company owns a minimum of 5.0% of the investee's outstanding voting stock, under the equity method of accounting. These investments are recorded at the amount of the Company's investment and adjusted each period for the Company's share of the investee's income or loss, and dividends paid.

During the year ended September 30, 2019, the Company recognized losses of approximately \$6.5 million. The losses related to its investment in South African Ventures, Inc. ("SAV") of approximately \$5.8 million, East Coast Packers LLC ("ECP") of approximately \$0.3 million, SOK Management LLC ("SOK") of approximately \$0.5 million and Tilstar Medical, LLC ("TIL") of approximately \$0.25 million.

Recently issued and adopted accounting pronouncements

The Company continually assesses any new accounting pronouncements to determine their applicability. When it is determined that a new accounting pronouncement affects the Company's financial reporting, the Company undertakes a review to determine the consequences of the change to its financial statements and believes that there are proper controls in place to ascertain that the Company's financial statements properly reflect the change.

We have considered recently issued accounting pronouncements and do not believe the adoption of such pronouncements will have a material impact on our consolidated financial statements.

See Note 2 to our financial statements beginning on page F-1 of this prospectus for a description of recent accounting pronouncements applicable to our financial statements.

OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any off-balance sheet arrangements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a "smaller reporting company" as defined by Item 10 of Regulation S-K, the Company is not required to provide this information.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The financial information required by Item 8 begins on the following page.

TABLE OF CONTENTS FOR FINANCIAL STATEMENTS